|  |  |
| --- | --- |
|  | **Division Bank and Insurance**  Austrian Federal Economic Chamber  Wiedner Hauptstraße 63 | P.O. Box 320  1045 Vienna  T +43 (0)5 90 900-DW | F +43 (0)5 90 900-272  E bsbv@wko.at  W http://wko.at/bsbv |

Your ref., Your message of Our ref., person in charge Extension Date

BSBV 64/Horvath 3141 4th May 2021

**Targeted consultation on the designation of a statutory replacement rate for CHF LIBOR**

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as legal representative of the entire Austrian banking and insurance industry, appreciates the possibility to comment on the above cited Consultative Document. We would like to note the following comments and remarks.

**1. ON THE EFFECTIVE NEED FOR A REPLACEMENT FOR CHF LIBOR**

Pursuant to Article 23a of the EU BMR, the Commission may only designate replacement rates for third-country benchmarks “if their cessation or wind-down would significantly disrupt the functioning of financial markets in the Union or pose a systemic risk to the financial system in the Union.”.

***Question 1. Do market participants agree that the situation as described above, requires that the Commission exercises the statutory replacement powers for the CHF LIBOR?***

***Please explain and provide data if available.***

a) Yes

b) No

c) No opinion.

In Austria, the CHF LIBOR used to play an important role in granting mortgages to private households. By the end of December 2020, an amount of EUR 10.8 bn of such CHF LIBOR linked loans to private households was still outstanding in the Austrian market (source: OeNB: ([https://www.oenb.at/isaweb/report.do?lang=EN&report=3.78](https://urldefense.proofpoint.com/v2/url?u=https-3A__www.oenb.at_isaweb_report.do-3Flang-3DEN-26report-3D3.78&d=DwMGaQ&c=SgupRstEQHpxMBBZGflc53FptCkuYd-P8O27DFHVMzE&r=u1_WR73x5qdJNTj_yJuuvA&m=604cElMila7JlMXji_W38EWRuBvROMPkl9J7KyvCYxo&s=VnjO7JxwzAwBBNfN-R5S4HuQ5SC_YgtLr9BopUqHu90&e=)).

The vast majority of these contracts was concluded in the years up until 2010, when neither the cessation of LIBOR was predictable, nor a specific replacement indicator was known.

Consequently, virtually none of the existing contracts contains a fallback language covering the permanent cessation of CHF LIBOR as it would only have been possible to use vague contractual wording such as referring to the usage of the economically closest indicator which could not have been named. The Austrian Supreme Court for civil law cases (“Oberster Gerichtshof, OGH”) qualifies such vague contractual agreements as a violation of the so called transparency requirement (“Transparenzgebot”) according § 6 (3) Austrian Consumer Protection Act and Article 4 (3), Art 5 Directive 93/13/EEC ("…insofar as these clauses are drafted in a clear and comprehensible manner"), because the consumer does not sufficiently know which specific indicator the bank would use instead of the indicator that was agreed between the two parties.

Also, the huge number of outstanding contracts would not allow the retrospective inclusion of a fallback clause covering the cessation of CHF LIBOR, as such a contract change would require the mutual consent of the client. As stated above, the strict transparency requirements towards consumers in Austria would not allow the insertion of a fallback clause that does not explicitly state and define which rate will be used as a successor rate and which was also not clear until recently[[1]](#footnote-1). Therefore, contracts that were concluded until some time after the coming into force of the EU BMR in 2018 do not contain a fallback clause either. Although the number of such contracts is very low, we would like to point out that we consider the restriction of the consultation to only include contracts that were concluded before 1 January 2018 as very critical. **In order to assure consistency and legal certainty, the designated replacement rate should apply to all contracts which do not contain fallback clause, regardless when they were concluded.**

In case the Comminssion explicitly seeks to stipulate a specific reference date until which the designated replacement rate shall be applied, we would consider the 5th of March 2021, the date of the FCA announcement on LIBOR cessation, as the most appropriate. Only after this date all the information necessary for assuring full transparency of fallback clauses, including the levels of the credit adjustment spreads, in consumer contracts been available.

The Swiss National Working Group has identified compounded SARON as the replacement rate for CHF LIBOR, which will be officially calculated and published by SIX, the SARON administrator.

In order to prevent contractual frustration, Austrian civil law provides that the resulting gap created by the loss of a value measure is to be filled by the closest comparative measure. Hence, if a contractually agreed value indicator, e.g. the reference interest rate for loans, ceases to be available, the economically closest reference value should be used instead. This ensures that the contract remains valid and a value transfer between contract parties is prevented. In case existing contracts referencing e.g. 3M CHF LIBOR, the economically closest rate would be the above-mentioned 3M SARON Compound, whereas an **Adjustment Spread** (calculated according to ISDA methodology) **shall be applied on top**, which is also recommended by the Swiss National Working Group and was confirmed by expert opinions from Prof. Pichler and Prof. Jankowitsch from the Vienna Business University and Prof. Graf from the University of Salzburg.

Since neither the working group recommendations nor the expert opinions have been officially endorsed by authorities and consumer protection groups in Austria, any contractual conversion according to the procedure described above does not offer the necessary legal certainty, as this would ultimately only be achieved by a court decision. **If there is no legal certainty when converting affected loans with consumers to SARON Compound + Adjustment Spread upon the end of CHF LIBOR,** there is still an **open risk that** such an approach would be **deemed inappropriate or illegal by a court decision**. Without any doubt, a situation like this would be **disruptive to financial stability and contractual continuity in Austria**. Therefore, it is important for both borrowers and lenders to have clarity on the reference rate + Adjustment Spread replacing CHF-LIBOR rates.

Compounded SARON plus Adjustment Spread is in itself compatible with the relevant Austrian consumer credit laws nationally implementing the Consumer Credit Directive and the Mortgage Credit Directive (Austrian Consumer Credit Act, “Verbraucherkreditgesetz - VKrG” and Mortgage and Real Estate Credit Act, “Hypothekar- und Immobilienkreditgesetz – HIKrG”) and the Consumer Protection Act.

In order to comply with the Austrian Consumer Credit Act and Mortgage and Real Estate Credit Act, which require that any change in the borrowing rate (including those caused by changes in the reference rate) for an interest period is communicated to the retail client (consumer) before it comes into effect (in-advance), the SARON Compound rate needs to be known at the start of the interest period. To make the rate known in advance, it is proposed to apply the rate compounded from daily SARON overnight rates over, e.g. the last three months in case of 3M SARON Compound to the following three months. As described in the consultation, this mode of applying an backward-looking compounded rate in advance is the so called the **“last-reset” convention** and would be the **only one compatible with legal provisions** when transitioning CHF LIBOR linked legacy business to SARON Compound.

**Further note on the adjustment spread according to ISDA methodology**

The purpose of an adjustment spread is to assure the economical equivalence of an unsecured term rate (LIBOR) and a compounded ON (nearly) risk free rate. It shall not create an advantage or disadvantage to neither of the contract parties. Its level can be positive as well as negative. Hence, the application of such a spread is per se not a compensation for the borrower.

In case of CHF LIBOR and SARON Compound, the Adjustment Spread levels according to ISDA methodology are as follows:

* 1M: -5.71 bps
* 3M: 0.31 bps
* 6M: 7.41 bps

Looking at the level for the 3M tenor (which is the most important also in the Swiss market), the statement by the Swiss National Working Group, that *borrowers can neglect the adjustment spread for simplification if it is beneficial for the customer*, is understandable, as the Adjustment Spread only amounts to 0.31 bps. Also, CHF LIBOR linked mortgages in Switzerland usually include a reference rate floor of zero. Hence, given the negative SARON and interest rate projections, the reference rate would anyway be zero for a longer period, with the adjustment spread included or not. On the other hand, flooring the reference rate at zero in contracts with consumers is legally not allowed in Austria, such a floor can only be applied to the total interest rate (reference rate + margin). Furthermore, we do not share the opinion that waiving the adjustment spread would assure simplification, neither from an operational nor from a legal perspective. The technical implementations for applying an adjustment spread anyway needs to be done, as with other products the adjustment spread will be applied and for consistency and clarity reason, a situation of “cherrypicking” should not evolve – this would be detrimental to legal certainty.

It is correct that, given the small adjustment spread for the 3M tenor, its waiver could be accepted by lenders and requested by consumer protection authorities. On the other hand, for the one-month tenor the level is negative, and no consumer protection agency would agree on waiving the adjustment spread. Given that all of the other major RFR Working Groups (ARRC, WG on Sterling Risk-Free Reference Rates, Cross-Industry Committees on Japanese Yen Interest Rate Benchmarks, WG on Euro Risk-Free Rates) were striving to achieve consistency across currencies and are recommending the application of a spread adjustment, not including it as part of a statutory fallback rate for CHF LIBOR would a.) undermine consistency efforts undertaken on global level and b.) not assure the transition to an economically equivalent reference rate. It is critically important to have a consistent approach, not only across currencies but also across products, where in many cases there are clearly defined fallbacks in place. Deviating from this standard for a specific product in a specific currency would create huge uncertainty, undermining the confidence in the overall process for future transitions in other currencies.

In our opinion, it would be expedient and sensible to quantify the Adjustment Spread (as an exact percentage rate, in nominal terms) in the Delegated Regulation. Since the Adjustment Spreads are known and fixed since 5th March 2021, that would be both possible and even more also useful in order to avoid disputes.

**In summary it can be stated that it is necessary for the EU Commission to designate a statutory replacement rate for CHF LIBOR by making use of its new powers granted under the amended EU BMR. This replacement rate shall be the SARON Compound with the Adjustment Spread as proposed by the Swiss National Working group and applied according to the “last-reset” convention. This is the only way to assure legal certainty for both borrowers and lenders and to prevent any event being disruptive to financial stability and contractual continuity in the European financial market.**

**We also would like to emphasize that the designation of a statutory replacement rate for CHF LIBOR would be the first real touching point of consumers with the EU BMR. Therefore, any measure by the EU Commission should bring clarity and not leave any open questions. That is why such a decision should not be limited to the 3M CHF LIBOR only, but consistency requires the same decision to be made for other CHF LIBOR tenors as well, no matter if the volume linked to such other tenors is significant or not. We would like to reiterate the importance of taking into account all tenors of CHF LIBOR (in particular 1M CHF LIBOR and 3M CHF LIBOR). Thus, the Commission shall designate the respective SARON (e.g. 1M SARON) compound with the adjustment spread as recommended by the Swiss NWG as a replacement rate for the respective CHF LIBOR (e.g. 1M CHF LIBOR).**

**Furthermore, we would like to draw the attention of the Commission to the issue of LIBOR-based products in other foreign currencies such as YEN, USD, GBP. Here a statutory successor regulation would also contribute to the legal certainty of existing consumer credit agreement.**

**2. ON THE FAIRNESS AND ACCEPTABILITY OF THE SOLUTION RECOMMENDED BY THE SWISS NATIONAL WORKING GROUP**

***Question 2. Do consumers, small and medium enterprises and relevant consumer bodies agree that the proposed replacement rate (3M SARON calculated as a compounded SARON under a last reset methodology) plus the ISDA adjustment spread (calculated as a historical median approach over a five-year lookback period) is a fair and equitable solution for a replacement of CHF LIBOR in mortgages and small business loans and consumer credit agreements? Please explain and, if necessary, provide alternative solutions.***

a) Yes

b) No

c) No opinion

As the question is obviously addressed to the consumer bodies, we do not deem it appropriate to provide an opinion and assume that consumer bodies will respond directly. However, pursuant to the following arguments we deem the proposed approach to be acceptable for consumers.

Regarding SARON Compound:

SARON Compound is the economically closest alternative to CHF LIBOR. This was also confirmed by an expert opinion via statistical assessment from Prof. Pichler and Prof. Jankowitsch from the Vienna Business University, where alternative rates (e.g. central bank rate) where examined as well (the document was already delivered to the EU Commission). Hence, its application shall find acceptance and be regarded as fair.

Regarding the application of the “last-reset” convention:

This convention is the only way to assure the compatibility with the requirements of the MCD and CCD (and their national implementation laws) to inform consumers on the change of the borrowing rate before the start of an interest period. Hence, there shall be no doubt that this will find acceptance and be regarded as fair.

Regarding the ISDA adjustment spread:

In the answer to question 1 we did provide arguments for the application of the adjustment spread. However, we are aware that the Austrian Ministry of Social Affairs (which has consumer protection on its agenda) sees its application critical, by arguing that the adjustment spread is not an existing market parameter, but a parameter that has been artificially created for the benefit of the lenders. We do not share this opinion for obvious reasons and given that the level of the adjustment spread for the one-month tenor is negative, not applying the adjustment spread for the one-month tenor would definitely be seen critical by consumer protection bodies. The only purpose of the adjustment spread is to assure economical equivalence, as the quality of the legacy and new reference rates is different: LIBOR being an unsecured term rate vs. SARON Compound being a compounded average of a secured ON rate. The situation of being able to “cherrypick” should not evolve, as any solution not bringing clarity and consistency would be detrimental to legal certainty (pls. see also answer to question 1).

**3. ON THE COMPATIBILITY OF THE CHOSEN METHODOLOGY WITH EU AND MEMBER STATES LAWS PROTECTING CONSUMERS**

***Question 3. Do market participants agree that the proposed calculation method (so called last reset) is compatible with the requirements of the MCD, the CCD, Directive 93/13/EEC and of other legislation protecting consumer credit and national implementation laws and with any other applicable legislation? Please explain.***

a) Yes

b) No

c) No opinion

The SARON Compound rate is only known at the end of the respective interest period for which it is calculated, which creates problems related to Austrian Consumer Credit Act (“Verbraucherkreditgesetz” - VKrG), and Mortgage and Real Estate Credit Act (“Hypothekar- und Immobilienkreditgesetz” - HIKrG), as these laws require any change in the borrowing rate (including those caused by changes in the reference rate) of an interest period being communicated to the retail client (consumer) before it comes into effect (in-advance). Hence, the SARON Compound rate needs to be known at the start of the interest period. The only option to assure this, is to apply the so called **“last-reset” convention**, which would be compatible with the relevant Austrian VKrG and HIKrG, which was also confirmed in a legal expert opinion by Prof. Graf from the University of Salzburg.

Yours sincerely,

Dr. Franz Rudorfer

Managing Director

Division Bank and Insurance

1. Minutes of the 29 September 2020 meeting of the National Working Group on Swiss Franc Reference Rates <https://www.snb.ch/n/mmr/reference/minutes_20200929/source/minutes_20200929.n.pdf>) [↑](#footnote-ref-1)